

**DECLARATION OF DR. MICHAEL L. KATZ
AND DR. STEVEN C. SALOP**

**USING A BIG FOOTPRINT
TO STEP ON COMPETITION:
EXCLUSIONARY BEHAVIOR AND
THE SBC-AMERITECH MERGER**

October 14, 1998

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I. INTRODUCTION AND QUALIFICATIONS

1. My name is Michael L. Katz, and I declare as follows. I am the Edward J. and Mollie Arnold Professor of Business Administration at the University of California at Berkeley. I hold a joint appointment in the Haas School of Business Administration and the Department of Economics. I serve as the Director of the Center for Telecommunications and Digital Convergence at the University of California at Berkeley. I have also served on the faculty of the Department of Economics at Princeton University. I received my A.B. from Harvard University *summa cum laude* and my doctorate from Oxford University. Both degrees are in Economics.

2. I specialize in the economics of industrial organization, which includes the study of antitrust and regulatory policies. I regularly teach courses on microeconomics, business strategy, and telecommunications policy. I am the author of a microeconomics textbook, and I have published numerous articles in academic journals and books. I have written several articles on issues regarding network effects, antitrust policy enforcement, and telecommunications policy, including access and interconnection policy. A copy of my curriculum vitae—attached to this Declaration as Exhibit 1—lists all publications that I have authored or co-authored, with the exception of a few letters to the editor on telecommunications policy. I am a coeditor of the *Journal of Economics and Management Strategy*.

3. In addition to my academic experience, I am a cofounder of The Tilden Group, LLC, a consulting firm that specializes in the application of economic analysis to issues

of antitrust and regulatory policy. I have served as a consultant to both the U.S. Department of Justice and the Federal Communications Commission on issues of public policy in telecommunications markets. I have served as an expert witness before various state and federal courts, and I have provided expert testimony before a state regulatory commission. In 1994 and 1995, I served as Chief Economist of the Federal Communications Commission (the Commission). In addition to advising the Commission on the full range of policy issues before it, I testified before Congress. Since leaving the Commission, I have spoken at several Commission public forums.

4. My name is Steven C. Salop and I declare as follows. I am Professor of Economics and Law at the Georgetown University Law Center, where I have taught since 1981. I received my bachelor's degree from University of Pennsylvania *summa cum laude* with honors in economics and my doctorate in economics from Yale University. Much of my research and teaching focuses on industrial organization economics and antitrust policy and law. I regularly teach courses in basic and advanced antitrust economics and law at the Law Center. I have also taught graduate courses in basic and advanced industrial organization at MIT and the University of Pennsylvania. I have written numerous scholarly articles that analyze oligopolistic competition, mergers, and exclusionary conduct. Among my articles in the area of the economics and law of exclusionary conduct are: "Raising Rivals' Costs," co-authored with David Scheffman; "Antitrust Analysis of Exclusionary Rights: Raising Rivals' Cost to Gain Power Over Price," co-authored with Thomas Krattenmaker; and "Market Power and Monopoly

Power in Antitrust Law,” co-authored with Thomas Krattenmaker and Robert Lande. I have also published an article on vertical mergers that analyzes vertical foreclosure, “Evaluating Vertical Mergers: A Post-Chicago Approach,” co-authored with Michael Riordan. A copy of my curriculum vitae is attached to this declaration as Exhibit 2.

5. In addition to my academic experience, I have consulted on a variety of matters involving telecommunications, many of which raise issues of network effects and the incentives for exclusionary conduct. These matters include the acquisition of McCaw Communications by AT&T, the attempted acquisition of MCI’s Internet assets by Worldcom, Primestar’s proposed acquisition of the MCI/NewsCorporation high powered direct broadcast satellite assets, and Time Warner’s acquisition of Turner Broadcasting.

6. We have been asked by counsel for Sprint to assess the effects of the proposed merger of SBC and Ameritech on the likelihood of exclusionary conduct by these carriers and the resulting ability of other carriers to bring competition to local exchange service and access markets in the United States.

7. In this declaration, we assess from the perspective of antitrust and industrial organization economics the effects on competition and consumers of exclusionary conduct flowing from the proposed merger of SBC and Ameritech. Drawing on our training and experience as economists, and our review of the relevant facts available to us, we conclude that—by threatening the entry and expansion of innovative rivals to the incumbent local service providers—the proposed merger raises significant public interest concerns.

II. OVERVIEW OF FINDINGS

A. Access to the ILECs' Networks is Efficient and in the Public Interest.

8. Because a subscriber to a network benefits from being able to communicate with others, and because of the potential inefficiencies associated with building overlapping facilities, it generally is efficient for carriers to rely on one another's facilities to complete calls made by subscribers on one network to subscribers on another. Thus, giving competitors access to the ILECs' networks generates significant benefits in terms of lower costs and higher quality of service.¹ Access can take several forms. In the case of two local exchange carriers, each carrier may purchase transport and termination from the other to complete calls originating on one network and terminating on the other. In the case of a local exchange carrier and interexchange carrier ("IXC"), the IXC interconnects with the local exchange network to obtain either originating or terminating access. Access can take other forms as well. For instance, a competitive local exchange carrier ("CLEC") may purchase unbundled network elements ("UNEs") from an incumbent local exchange carrier ("ILEC"). The purchase of UNEs can be viewed as a form of access or interconnection because it allows a carrier to use its facilities in combination with those of another carrier (*i.e.*, the ILEC) to deliver services to end users.

¹ See, for example, Katz, Michael L., Gregory Rosston, and Jeffrey Anspacher, "Interconnecting Interoperable Systems: The Regulators' Perspective," *Information Infrastructure and Policy*, 4 (1995):327.

In what follows, we generally will use the term *access* to include all these forms of access and interconnection.

9. The need for, and value of, access arises whenever there are multiple carriers providing public services. Thus, the need for access will not disappear even if local competition takes hold. Indeed, the availability of high-quality, efficiently priced UNEs and interconnection among local networks is a necessary structural prerequisite for local exchange markets to make the transition to competition. In the presence of such an interconnection policy (for both UNEs and transport and termination), CLEC investment in local telecommunications infrastructure is stimulated by the fact that a carrier can count on being able to use its infrastructure to provide services that also rely on the availability of access to the ILEC's network on reasonable terms. The availability of access to local exchange carriers (in the form of originating and terminating access) similarly stimulates investment in interexchange services, including advanced telecommunications services. Carriers like Sprint that are investing in services that combine local and long distance offerings in integrated packages (combined service carriers, or "CSCs") also will have greater investment incentives for both reasons.

B. The Merger of SBC and Ameritech Poses a Significant Threat to the Provision of Efficient and Innovative Access and thus Poses a Significant Threat to Competition.

10. Efficient access is essential to realizing the full benefits that telecommunications networks can provide. Unfortunately, the proposed merger between SBC and Ameritech poses a significant threat to the provision of efficient access by increasing the companies'

incentives and ability to carry out exclusionary access policies. Our economic analysis concludes that:

- CLECs, IXC, and CSCs all will continue to depend on ILEC access services (*i.e.*, UNEs as well as various forms of originating and terminating access services) in order to be able to provide commercially viable services themselves. CLECs, IXC, and CSCs will need an array of new and innovative forms of access in the future.
- Ameritech and SBC currently possess significant market power in the provision of access services in their respective service regions. This market power may be exercised by setting high access prices (in the absence of price regulation) or by pursuing exclusionary access policies under which Ameritech and SBC delay, deny, or degrade the access provided to other carriers.²
- By permitting effective coordination between what are today separate and independent local exchange operations, the proposed merger of Ameritech and SBC would increase both parties' incentives and ability to disadvantage CLECs, IXC, and CSCs by reducing their provision of the high-quality, efficient, and innovative forms of access that those competitors will require to compete.
- Regulation is an imperfect check on the exercise of ILEC market power. The proposed merger would make it even more difficult for the state and federal policy makers to prevent SBC and other ILECs from refusing to provide efficient, high-quality and innovative access at reasonable prices.
- The proposed merger of SBC and Ameritech thus poses a significant threat to telecommunications competition and the public interest.

11. In the remainder of this Declaration, we explain the economic logic and factual analysis that has led us to these conclusions.

² Throughout, we use the term *exclusionary* to refer to practices that impair the ability of rival firms to compete, even if the practices do not drive the rivals completely out of the market. Thus, it includes conduct that impairs rivals' quality, raises rivals' costs, slows rivals' entry or expansion, as well as similar conduct.

III. SBC AND AMERITECH POSSESS SUBSTANTIAL MARKET POWER IN THE PROVISION OF ACCESS

12. A first step to analyzing whether the merger poses the threat of anticompetitive behavior is to assess whether SBC and Ameritech possess substantial market power in the provision of access services. In particular, we are interested in the question of whether SBC and Ameritech have the ability to disadvantage rival carriers by refusing to provide access on efficient and reasonable terms. In this section we briefly review the evidence that they do.

A. For Many Customers and Services, there are No Economic Substitutes for ILEC Access Services.

13. In analyzing the market power of the ILECs and their incentives to exclude rivals, both upstream and downstream markets are relevant.³ First, there are *downstream* product markets for various retail services, including local exchange services, interexchange services, and combined (local exchange and interexchange) services.^{4,5}

³ For a discussion of market definition, see the Declaration of John B. Hayes, "Market Power And The SBC-Ameritech Merger," October 14, 1998 and *In the Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, FCC 97-286, *Memorandum Opinion and Order*, released August 14, 1997, at 49-57. For a discussion of market definition in the context of exclusionary conduct see Thomas Krattenmaker, Robert Lande and Steven Salop, "Monopoly Power and Market Power in Antitrust Law," *Georgetown University Law Review* 76 (1987):241.

⁴ Wireless providers also offer local and interexchange services. Wireless services are differentiated by mobility and, at present, generally do not compete directly with wireline services. The issues, however, are very similar for wireline and wireless carriers seeking ILEC access services, and we write below using wireline terminology as a short hand for all types of interconnection and access.

Second, there are *upstream* product markets for the provision of access services to carriers who are in turn providers of retail telecommunications services. For example, an IXC participates in the downstream market as a provider of long distance services to end users, and the IXC participates in the upstream market as a buyer of access services (originating and terminating access). Similarly, CLECs are sellers in downstream local exchange markets and are buyers of UNEs and transport and termination in upstream markets.⁶

14. ILECs have monopoly power in the provision of access services to CLECs, CSCs and IXCs. This conclusion follows directly from the fact that these carriers currently have no economically feasible alternatives to the use of ILEC facilities (whether through the purchase of UNEs, transport and termination, interexchange access, or local exchange resale) to reach the vast majority of telecommunications subscribers in the U.S.

15. The absence of viable substitutes for SBC and Ameritech's access services that would otherwise limit their market power can be seen from available market share data.

⁵ Combined services compete with both local and interexchange services, and some industry observers believe that the three markets may blend into one in the future. For simplicity of exposition, we treat local exchange, interexchange, and combined services as three separate product markets. However, the results of our analysis would not be changed if markets evolved to the point where combined services constituted the sole downstream product market. Similarly, our analysis applies to the situation in which combined services do not yet constitute a distinct relevant market.

⁶ Of course, a CLEC may also be a seller in upstream markets, providing transport and termination to other local exchange carriers and originating and terminating access to IXCs. By excluding CLECs, an ILEC can maintain this market power in the upstream

The ILECs' shares of access lines exceeded 98.5 percent in the first two states for which Ameritech and SBC filed Section 271 applications for long-distance authority. In Michigan, the aggregate market share for CLEC's fell between 1.2 and 1.5 percent.⁷ And the U.S. Department of Justice found that Southwestern Bell's "market share in Oklahoma is so near 100 percent as to be practically indistinguishable from a complete monopoly."⁸ And these are states in which Ameritech and SBC have (unsuccessfully) represented that local exchange markets are open to competition. Moreover, even the 1.5 percent share for CLECs overstates the options for a carrier seeking to reach most residential subscribers—competitive carriers' access lines are highly concentrated in urban areas and for business subscribers.

16. Market shares alone do not tell the whole story. However, examination of the conditions of entry confirms the conclusion that ILECs have significant market power as providers of access services. There are high barriers to entry facing potential entrants into the provision of access services in competition with the ILECs. First,

access markets.

⁷ See *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide in-Region, InterLATA Services in Michigan*, CC Docket No. 97-137, *Evaluation of the United States Department of Justice*, filed June 25, 1997, at B3. These share data are for switched access. Resold lines are included in the CLECs' share for these calculations.

⁸ *In the Matter of Application by SBC Communications Inc., Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in Oklahoma*, CC Docket No. 97-121, *Evaluation of the United States Department of Justice*, filed May 16, 1997, at 52.

telecommunications markets are characterized by strong network effects. Thus, any CLEC seeking to offer public telecommunications services must itself interconnect with ILEC local exchange networks to be competitively viable.⁹ The need to interconnect with the ILECs' networks to realize network effects will continue as long as ILECs remain the only way to connect to significant numbers of end users. This need to interconnect with the ILECs' networks gives ILECs the power to reduce the threat of entry by raising entrants' costs, either by raising the price of access or by denying, delaying or degrading the necessary access. In addition to network effects, there are economies of scale (density) in providing access services. Local network infrastructure has large fixed costs that must be incurred even if the carrier is serving only a small percentage of telephone subscribers in a given area. Thus, small-scale entry is difficult, which raises the cost of entry.

17. SBC might argue that an ILEC needs interconnection as much as other carriers, but the facts indicate otherwise. A CLEC, IXC, or CSC seeking access services from the ILEC needs that interconnection much more than does the ILEC. To see why the bargaining positions are unbalanced, consider what would happen if the interconnection negotiations between an ILEC and a CLEC were to break down. If the parties failed to reach any

⁹ There is one limited exception. A firm offering solely originating and/or terminating interexchange access could offer service without directly connecting to an ILEC network. That carrier's IXC customers, however, would still need to purchase access from ILECs to reach the vast majority of telecommunications subscribers.

interconnection agreement at all, the CLEC would likely be forced out of business as the result of being unable to offer its customers the ability to call to and from the ILEC's network. Given the comparatively low share that any CLEC has today, the ILEC could largely continue with business as usual. Indeed, not only would the ILEC not be significantly harmed by the lack of interconnection with the CLEC, the ILEC would positively benefit from the weakening of competition and the diversion of customers to its own retail services.

18. The bargaining between an IXC and an ILEC is similarly one-sided. Because competition among local carriers is so limited, an IXC typically has only a single means of reaching the vast majority of potential subscribers in a given geographic area, the ILEC. A given ILEC, however, will be dealing with multiple IXCs and may be able to discriminate among them.¹⁰ Indeed, in the future, SBC may be discriminating in favor of its own interexchange services. If an IXC cannot provide high quality service for calls that originate or terminate in a significant portion of the country, then that carrier can expect to lose significant amounts of traffic to rival IXCs. An ILEC that offers a particular IXC poor interconnection, however, faces much less of a threat that it will see the bulk of its customers turn to other local carriers. Thus, the bargaining positions of an ILEC and an IXC are asymmetric.¹¹

¹⁰ As we discuss further below, while such discrimination would typically violate state and/or federal regulatory policy, such policies cannot be perfectly enforced.

¹¹ The bargaining power between the ILEC and a CSC could be one-sided for the reasons identified for both CLECs and IXCs.

19. The Commission itself has long recognized that ILECs possess substantial market power; indeed, this recognition is the basis of the Commission's regulation of interstate access charges as well as the terms of interconnection between ILECs and commercial mobile radio service providers.¹² Moreover, the interconnection provisions of Telecommunications Act of 1996 also are based on recognition of ILEC market power.¹³

B. Competitive Services Such as Sprint ION Will Increasingly Need Innovative New Access Arrangements With ILECs

20. Sprint ION is an innovative new service that promises to bring the benefits of an integrated package of advanced telecommunications services to millions of subscribers. Sprint ION is a combined service that has both local and long distance components for both data and voice. The service integrates traditional voice traffic, Internet traffic, frame relay traffic, and other data traffic on one customer access facility and carries this traffic in the Asynchronous Transfer Mode data format through the Sprint network.¹⁴ For communications terminating to end users that are not Sprint ION customers, Sprint will convert the Sprint ION format to the formats needed to communicate with the non-Sprint ION customers at a Sprint Service Node.

¹² See, for example, *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, *Notice of Proposed Rulemaking*, released January 11, 1996.

¹³ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§ 151 et. seq.

¹⁴ For a more complete description of Sprint ION, see Affidavit of Kevin E. Brauer (*Brauer*

21. After an initial roll out period, Sprint plans to increase the functionality of Sprint ION service to include the ability to combine what had previously been local voice calling with other communications on the all-distance Sprint ION platform. Sprint ION will allow a customer to integrate its local service with all of its other services using a single access facility to the customer premises. Once fully deployed, Sprint ION can help bring competition to local exchange markets—something that, to date, has been almost non-existent.¹⁵

22. Innovative CSCs like Sprint are particularly vulnerable to exclusionary access policies by the ILECs because these CSCs need the timely availability of access services from the ILECs for which adequate regulatory safeguards do not exist. Sprint will rely on dedicated access to reach large customers and will offer Sprint ION to smaller customers through alternative means, such as xDSL. Sprint plans to implement xDSL by collocating its xDSL equipment in ILEC central offices in order to make use of ILEC unbundled loops.

23. The roll-out of Sprint ION requires innovative access arrangements for which there are not existing standards or benchmarks, and there are a variety of ways in which the ILECs can drag their feet or otherwise fail to provide high-quality access on efficient

Affidavit) at 2-6.

¹⁵ It is, however, important to recognize that, for the vast majority of residential subscribers, Sprint will remain dependent on ILEC to provide significant underlying local facilities.

terms. Three problems that have arisen and can be expected to worsen if the proposed merger is approved are: (a) the provision of Operational Support System (“OSS”) capabilities; (b) access to ILEC central offices and other facilities so that a competitive carrier may collocate its equipment with those of the ILEC; and (c) the availability of suitably conditioned ILEC facilities that are provided on an unbundled basis.

24. With regard to OSS, Mr. Brauer of Sprint has testified that “OSS and related problems at the RBOCs (including SBC and Ameritech) result in a significant loss of revenue to Sprint due to delayed cut-over of service, loss of customers and damage to Sprint’s reputation as a quality telecommunications provider.”¹⁶ The Commission itself is no stranger to the difficulties of setting OSS standards, as they have proved to be one of the more contentious issues in the 271 proceedings.

25. Turning to access to ILEC facilities, Mr. Brauer raises a number of concerns. For instance, many loops are behind Digital Loop Carrier (“DLC”) equipment that prevents the provision of xDSL service on these loops. The RBOCs as a rule have refused to entertain requests to collocate CLEC equipment at RBOC DLC locations and to perform sub-loop unbundling for the twisted-pair copper from the DLC to the end user premises.¹⁷ Other parties have raised concerns about collocation. For example, Covad Communications Company, a California-based digital subscriber line (“DSL”) provider,

¹⁶ *Brauer Affidavit* at 12.

¹⁷ *Brauer Affidavit* at 14-15.

has complained that its expansion efforts have been hampered by SBC's physical collocation practices. In comments filed with the Commission, Covad asserts that SBC had unilaterally declared that no space existed in at least 50 of the 165 central offices in which Covad had applied for collocation, but that it later became clear through an SBC ADSL Service tariff filing that SBC was able to find room for its own DSL equipment in 20 of those 50 central offices.^{18,19}

26. The technical capability of ILEC facilities will be a particularly important issue when Sprint and others begin to use unbundled loops to provide xDSL service. Many existing local loops will require individual treatment in terms of conditioning in order to carry the high-speed digital signals directly to the customers' premises. Moreover, the ongoing performance of the conditioned loops depends largely upon whether interfering digital signals are carried within the same cable sheath or binder. The conditioning of the loops and the placement of digital signals within a binder group of loops provide two

¹⁸ *In the Matter of Southwestern Bell Telephone Company, Pacific Bell, and Nevada Bell Petition for Relief from Regulation Pursuant to Section 706 of the Telecommunications Act of 1996 and 47 U.S.C § 160 for ADSL Infrastructure and Service*, CC Docket No. 98-91, *Comments of Covad Communications Company*, filed June 1998, 24, at 4-5.

¹⁹ SBC was eventually able to accommodate Covad equipment in many of these offices, but only after Covad filed an antitrust lawsuit for a preliminary injunction. See *In the Matter of Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 98-147, *Comments of Covad Communications Company*, filed September 25, 1998, at 6-7.

mechanisms through which an ILEC can degrade the quality of access services provided to Sprint and other CSCs or CLECs.²⁰

IV. ILECS' PRIVATE INCENTIVES TO OFFER ACCESS AND INTERCONNECTION DO NOT ALIGN WITH THE PUBLIC INTEREST

27. In evaluating the public interest effects of the proposed merger between Ameritech and SBC, policy makers must take into account two fundamental points. First, even without the proposed merger, both SBC and Ameritech have unilateral incentives to exercise market power in the provision of access in ways that do not serve the public interest. Second, the proposed merger will increase these incentives. The remainder of this section examines these incentives in the absence of the proposed merger. Sections V and VI then examine the ways in which the proposed merger would increase SBC and Ameritech's incentives and ability to engage in anticompetitive behavior.

A. ILECs have Incentives to Exercise Market Power in the Provision of Access

28. A profit-maximizing ILEC has incentives to exercise market power in the provision of access services and, in the absence of effective regulatory constraints, will do so. Even if an ILEC did not compete downstream in either the local exchange, interexchange, or CSC markets, that ILEC would have incentives to exercise market power as a seller of access services by setting high prices. Moreover, because it does compete in the downstream

²⁰ *Brauer Affidavit* at 13-15.

markets, an ILEC has further incentives to raise the price and incentives to deny, delay or degrade the provision of access to its competitors as a means of disadvantaging these competitors.²¹

1. Monopoly pricing of access by an unintegrated access monopolist

29. The first reason why an ILEC may seek inefficient, non-competitive terms for access comes under the general rubric of monopoly pricing by an unintegrated access monopolist. An ILEC can be expected to elevate its access charges above costs to the extent that regulators and the elasticity of demand allow it to do so profitably. An ILEC with significant market power in the provision of access has the incentive to set monopolistic access prices in order to extract greater economic rents for itself. Thus, even an ILEC that did not compete with the carriers to whom it was selling access could be expected to charge inefficiently high prices for that access.²²

²¹ See, for example, Michael L. Katz, "Economic Efficiency, Public Policy, and the Pricing of Network Interconnection Under the Telecommunications Act of 1996," in *Interconnection and the Internet: Selected Papers from the 1996 Telecommunications Policy Research Conference*, G. Rosston and D. Waterman (eds.), Mahwah, New Jersey: Lawrence Erlbaum Associates, Publishers (1997).

²² When an ILEC has limited information about the exact economic value that each interconnecting provider places on access, the ILEC cannot transfer economic rents efficiently to itself from interconnecting carriers.

2. Raising rivals' costs with price and non-price exclusionary conduct

30. The second reason why an incumbent LEC may seek inefficient, non-competitive terms for the provision of UNEs, interexchange access, and transport and termination falls under the general heading of raising rivals' costs.²³ ILECs compete, or have plans to compete, against the carriers to whom they sell access services. At present, SBC and Ameritech compete with CLECs in the provision of local services (albeit to a limited extent) and with IXC in the provision of intraLATA toll services. SBC and Ameritech also are planning to compete with IXC and CSC in the provision of interLATA services in the future. By raising the costs (or degrading the quality, or delaying or denying access)²⁴ of competing carriers' services, SBC and Ameritech can achieve, enhance, or maintain market power in the retail markets in which they compete with these disadvantaged rivals.

31. An ILEC has incentives to disadvantage actual and potential entrants in both the local exchange services and interexchange services markets in which it participates or plans to enter in the near future. While there are significant differences between local and long-distance markets in terms of the degree of competition and the role of ILECs, there is one common factor: ILECs control necessary access to the vast majority of telephone subscribers.

²³ See, for example, S. Salop and D. Scheffman. "Raising Rivals' Costs," *American Economic Review Papers and Proceedings* 73 (May 1983):267; T. Krattenmaker and S. Salop, "Antitrust Analysis of Exclusionary Rights: Raising Rivals' Costs to Gain Power Over Price," *Yale Law Journal* 96 (December 1986):209.

²⁴ We refer to all of these forms of exclusionary conduct collectively as "raising rivals'

By denying efficient access to CLECs and CSCs, an ILEC is able to sustain its market power in the provision of local exchange services.²⁵ The vigor with which ILECs have used legal and regulatory maneuvers to resist the introduction of competition suggests that their current market positions are very valuable. By denying efficient access to IXCs and CSCs, an ILEC also may be able to create an artificial—and profitable—competitive advantage for its own in-region interexchange operations.

32. Rivals may be disadvantaged in a number of ways, by both price and non-price means. One way to raise rivals' costs is to increase the charges for access. A firm generally benefits from an increase in the marginal costs faced by its rivals because such cost increases raise the rivals' profit-maximizing prices and reduce their profit-maximizing output levels at current prices. And raising the costs of *potential* rivals may delay or deter their entry. Put another way, by charging its competitors more for originating and completing their customers' calls, an ILEC can drive up the retail prices of these competitors, to its own benefit and consumers' detriment. In addition, by disadvantaging CLECs and CSCs that might themselves offer access services, the ILEC also maintains its market power in the provision of access services in the upstream market. Thus, an ILEC can have incentives

costs.”

²⁵ This incentive to exclude CLECs and CSCs exists even before Section 271 approval is granted to the ILEC. For a further discussion of the constraints created by Section 271, see ¶59 below.

to charge wholesale access prices above the monopoly prices that would have been set by an unintegrated access monopolist that did not compete with its customers.²⁶

33. A second general method of disadvantaging rivals is by denying, delaying, or degrading provision of the access needed to support the services these competitors provide to consumers. As discussed in Part III.B above, there are many different ways in which an ILEC can disadvantage its rivals through its control of essential access services and facilities. For example, consider a CSC with an innovative new combined service that it would like to offer in competition with an ILEC. Suppose this CSC entrant can offer the service efficiently only if it obtains a particular type of access arrangement from the ILEC. The ILEC's refusal to provide that access in a timely fashion could destroy the entrant's ability to compete. In less extreme circumstances, this refusal will raise the entrant's cost of competing or reduce the quality of its service offerings. Either way, the CSC will be a weaker competitor in both the local exchange and interexchange markets, permitting the ILEC to profit in both of these markets. As discussed in Part IV.D below, this second type of exclusion is very hard for policy makers to monitor, and we believe that it is impossible for policy makers fully to prevent abuse. As regulators succeed in

²⁶ It does not automatically follow that any vertically integrated firm will want to disadvantage its customers in order to promote its own downstream division. The integrated firm must balance the foregone profits from lost upstream sales against the increased profits of its downstream division. Under some conditions, it will not be profitable to elevate the input price charged to downstream rivals. We address the specific incentives of SBC and Ameritech in the downstream markets below.

holding down the charges for various types of access services to lower levels, an ILEC gains the incentive to employ these non-price means to raise rivals'

costs.^{27,28} The threat of non-price exclusionary conduct is particularly strong against CSCs that require innovative access arrangements that are the most difficult for regulators to monitor effectively. And, as a new entrant trying to roll out its services rapidly on a nationwide basis, a CSC is very vulnerable to ILECs' actions that delay or degrade the CSC provider's ability to offer service.

B. A Formal Model of ILEC Incentives to Exclude Competition with Exclusionary Access Policies

34. In this part, we develop a simple, formal analytic framework and apply it to the issue of exclusionary conduct directed at competing CLECs, IXC's, or CSCs. As discussed earlier, SBC and Ameritech have and will continue to have substantial market power in the provision of access services required by CLECs, IXC's, and CSCs. For any

²⁷ If access and interconnection prices were fully unregulated, then the ILEC may not have the incentive to use these non-price means of exclusion. This conclusion follows from the fact that increasing the price of access generates increased revenue in the upstream market at the same time that it disadvantages rivals in the downstream market. Note that in situations where price discrimination is infeasible but non-price discrimination is not, the ILEC may have the incentive to use non-price means of exclusion even when interconnection fees are unregulated.

²⁸ There is considerable evidence of exclusionary conduct by the ILECs. For a discussion, see Declaration of Stanley M. Besen, Padmanabhan Srinagesh, and John R. Woodbury, "An Economic Analysis of the Proposed SBC/Ameritech Merger," October 14, 1998.

unregulated access services,²⁹ SBC and Ameritech will have the ability to raise access prices in order to disadvantage rivals. For regulated access services, SBC and Ameritech will have the incentive to raise competitors' costs by denying, delaying, or degrading access, if regulators cap access prices sufficiently below the (integrated firm) monopoly price.

35. By engaging in non-price exclusionary conduct, SBC and Ameritech sacrifice profits from the sale of wholesale access in return for increased market power in the provision of local exchange, interexchange, and combined services. The carriers also run the risk of incurring regulatory sanctions in the event that the regulators are able to detect and punish this exclusionary conduct.³⁰ To choose the degree to which to carry out such exclusionary conduct, an ILEC must balance the benefits of exclusion against these costs. In part, the benefits depend on the way in which the ILEC exercises the increased market power that results from exclusionary conduct. In this section, we develop two expressions for the ILEC's incentives to engage in non-price exclusionary conduct, which we refer to as the *relative-margin incentive* and the *increased-price incentive*.

²⁹ For example, certain broadband access services might not be regulated in the future.

³⁰ As discussed below, the ability of regulators to detect exclusionary behavior is limited. However, the greater the extent of exclusionary conduct, the more likely it is that the ILEC will be caught and punished.

1. The Relative-Margin Incentive

36. The *relative-margin incentive* is based on a scenario in which the ILEC increases its retail unit sales at current prices in response to the weakening of competition.

Suppose that SBC pursues this strategy. In this case, the exclusion permits SBC to replace upstream sales of *access* to competitors with a certain quantity of downstream *retail* sales to end users.³¹ Algebraically, we can express this relationship as

$$\text{Gain from Exclusion} = \Delta Q^r \times m^r - \Delta Q^a \times m^a \quad . \quad (\text{eqn. 1})$$

where ΔQ^r is the additional retail traffic that SBC gains as a result of the exclusionary behavior, m^r is the margin (price minus incremental cost) that SBC earns on those retail services, ΔQ^a is the volume of access services that SBC loses as a result of the fact that rivals no longer purchase as much access when SBC engages in exclusionary behavior, and m^a is the margin that SBC would have earned on those access services. In other words, Equation (1) implies that, if the incremental retail business gained is more profitable than the incremental access business lost, then SBC would have incentives to exclude its rivals in the particular retail segment.

³¹ This condition is sufficient, but not necessary. Even if this scenario is not profitable at current prices, it nonetheless may be profitable to exclude if SBC increases its retail price somewhat instead of increasing its output by the full amount of the reduction in its rivals' output. For regulated services facing new competition, preventing price from falling is treated as a price increase.

37. This general framework can be applied to exclusionary access conduct directed towards the CLECs, IXCs, and CSCs. When excluding CLECs, SBC sacrifices wholesale access volume and revenues, but gains retail local exchange volume (both in terms of lines and, in the case of local measured service, minutes).³² When excluding IXCs, SBC trades the loss of switched and special access traffic against the gain in retail long distance traffic. When excluding CSCs, increased local and long distance profits are weighed against lost access profits. Moreover, as access charges are adjusted toward cost-based levels, m^a will fall and the ILEC's incentive to engage in non-price exclusionary conduct will rise.

38. The change in profits also has to be balanced against the risk of regulatory sanctions. Let S denote the expected sanctions when the ILEC engages in amount d of exclusionary behavior. One would expect S to rise as d rises for two reasons. One, the probability of detection will increase as the behavior becomes more egregious. Two, the penalties levied upon detection may increase in the level of activity undertaken. To capture this relationship between S and d , we write $S(d)$. The volume changes will also depend on d , so we express them as $\Delta Q^r(d)$ and $\Delta Q^a(d)$. Using this notation, SBC has incentives to choose the level of exclusionary conduct to maximize its gains net of enforcement costs,

³² In the longer run, the SBC may not be sacrificing much wholesale traffic. By disadvantaging the CLECs, SBC can raise barriers to entry into the *access* market and

$$Net\ Gain = \Delta Q^r(d) \times m^r - \Delta Q^a(d) \times m^a - S(d) \ . \text{ (eqn. 2)}$$

39. One can express this simplified scenario in more detail to facilitate computation of a particular ILEC's incentives to engage in exclusionary conduct. Suppose that SBC delays, denies, or degrades the provision of access by amount d , and these actions lead its competitors in one of the retail markets to reduce their collective retail unit sales by $\Delta Q(d)$ at the current retail price. Suppose that a fraction, δ , of these sales are diverted to SBC at the current retail price; in other words, SBC's unit sales rise by $\Delta Q^r = \delta \Delta Q(d)$. The proportion δ is known as the *diversion ratio*.³³ If the services are perfect substitutes, then $\delta = 1$. For differentiated products, $\delta < 1$.

40. The increase in d will also reduce SBC's sales of access minutes to other carriers; as they cut back their retail sales, other carriers will have less demand for SBC access services. We use λ to denote the amount of access traffic that SBC loses due to its exclusionary behavior, expressed as proportion of the retail traffic that the disadvantaged carriers lose.³⁴ The value of λ calculated over all lost traffic will depend on the mix of traffic. Using this notation, we have $\Delta Q^a = \lambda \Delta Q(d)$.

better maintain its market power in the provision of these services.

³³ For additional discussion, see Carl Shapiro, "Mergers with Differentiated Products," *Antitrust* (Spring 1996):23.

³⁴ Suppose, for example, that SBC has received Section 271 approval and disadvantages all other IXC's purchasing access services from it. Further, suppose that these carriers cut back their retail sales by 100 minutes and that carriers reduce their purchases of access

41. Armed with this new notation, we can re-write Equation (2) as

$$Net\ Gain = \Delta Q(d) \times \{ \delta \times m^r - \lambda \times m^a \} - S(d) . \quad (eqn. 3)$$

As long as the *relative margin*, $\delta \times m^r - \lambda \times m^a$, is positive and it is difficult for regulators to detect a small increase in exclusionary conduct, SBC has incentives to raise rivals' costs.³⁵

2. The Increased-Price Incentive

42. A second sufficient condition for the profitability of raising rivals' costs also can be formulated. The *increased-price incentive* is based on a different scenario in which SBC exercises its increased market power (which results from its exclusionary conduct) by holding its output fixed and obtaining a higher price (than would occur otherwise). As in the previous scenario, exclusion that reduces rivals' retail output by $\Delta Q(d)$ units reduces SBC's sales of access by $\Delta Q^a = \lambda \Delta Q(d)$ units, and thus reduces its access profits by $\lambda \Delta Q(d) \times m^a$. The difference between the two scenarios comes in the retail market. Now, instead of increasing its output level, SBC gains from a price increase, $\Delta p(d)$, times

from SBC by 150 minutes. Then, in this example, λ would be equal to 1.5 (*i.e.*, 150/100).

³⁵

If the access price were unregulated and price discrimination were feasible and unconstrained, then the incentive to exclude by degrading, delaying, or denying access would disappear because SBC would increase the price of access (and thus m^a) instead. As noted earlier, restrictions on the access margin increase the ILEC's incentives to engage in non-price exclusionary conduct.

the SBC's output in the retail market Q_i . The gain in retail profits is thus $Q_i \times \Delta p(d)$.³⁶

Taking the expected sanction, $S(d)$ into account,

$$\text{Net Gain} = Q_i \times \Delta p - m^a \times \lambda \times \Delta Q(d) - S(d) . \quad (\text{eqn. 4})$$

43. Even if regulators capped retail prices at levels leading to a retail margin so low that the *relative-margin* incentive were negative, the *increased-price incentive* still may be satisfied. This latter incentive may also be satisfied even when regulators prevent the ILEC from raising retail prices. This outcome is possible because exclusionary access policies raise or maintain barriers to entry and expansion. These barriers can permit the ILEC to profitably maintain the current regulated price rather than being led to *reduce* retail prices to meet the threat or actuality of new competition. In this way, the ILEC's exclusionary conduct prevents price from falling to a lower, more competitive level.

Deterring such price decreases is, of course, an exercise of market power.³⁷

44. It also is important to emphasize that these expressions may understate actual incentives. They are based on the assumption that the ILEC exercises its market power either (a) solely by increasing output at the current price, or (b) solely by taking a higher price (or forestalling a price decrease) on current output. These calculations ignore the

³⁶ David S. Sibley and Dennis L. Weisman, "The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," *Journal of Policy Analysis and Management* 17 (1998):74, take a similar approach.

³⁷ See Krattenmaker, Lande and Salop, *supra* note 3. In what follows, we will include in the meaning of "raising price" the conduct of "preventing price decreases."

potential for the ILEC to choose a possibly more profitable intermediate combination of higher price and higher output.

3. An Illustrative Example

45. This part illustrates the *relative-margin incentive* in a calibrated simulation to show that an ILEC can have significant incentives to engage in exclusionary conduct. The particular example considered involves an ILEC delaying the provision of essential facilities required by a hypothetical CSC planning to offer single-line business customers a bundle of local and long distance services.³⁸ The ILEC's net gains from delaying or deterring the hypothetical CSC's entry are computed below. These computations are illustrative. A given ILEC's incentives to exclude a rival depend, in part, on the business models of both the ILEC and the specific rival, so we first discuss those business models. We then compute the ILEC's upstream and downstream margins to allow calculation of the *relative-margin incentive*.

46. The hypothetical CSC has a business model in which its usage-sensitive charges mirror those of current ILEC and IXC usage-sensitive charges, but the monthly fees are lower than those charged by the ILEC and IXCs.³⁹ As a consequence, we assume that the

³⁸ Actual CSCs are expected to build networks that can offer the full range of local and long distance services that are available from LECs and IXCs today plus new advanced services and applications that can be used when *both* ends of the call are directly attached to a CSC network. We return to the effects of these additional services below.

³⁹ Subscribers might also be attracted to the CSC by the convenience of integrated billing if the ILEC cannot offer this feature.

usage pattern of a given customer will not change when he or she shifts to the CSC.

47. Suppose that the CSC offers its bundle of local and long distance services over a mix of owned facilities and UNEs leased from the ILEC. In particular, the CSC is assumed to: (a) own its long-distance network;⁴⁰ (b) provide service over unbundled loops purchased from the ILEC; (c) provide its own local switching; and (d) use transport leased from a CAP.

48. The ILEC in our hypothetical example is assumed to provide local services and in-region long distance services over its own network facilities.⁴¹ The ILEC is assumed to purchase bulk long distance minutes from an IXC to transport calls from its subscribers that terminate outside of the ILEC's region.⁴² The ILEC earns terminating access charges on long-distance calls from subscribers outside the ILEC's region to its local exchange subscribers. In addition, the ILEC earns interstate and intrastate access charges on in-region calls originated by other carriers operating in its region, and it pays applicable terminating access charges to other carriers whose in-region subscribers are called by

⁴⁰ Equivalently, the CSC could lease a network or purchase bulk capacity from a carrier other than the ILEC.

⁴¹ Local calls from the ILEC's subscribers to competing CLECs are assumed to be in balance and reciprocal compensation rates are assumed to be symmetric. Thus, the ILEC's payments for originating local calls that terminate on CLEC networks equal the payments ILEC receives for terminating calls that originated on CLEC networks.

⁴² These calls are terminated over the facilities of the access providers serving that region, and terminating access charges are paid on this traffic.

ILEC customers.⁴³

49. We next evaluate the *relative-margin incentive* in this example. We assume that the ILEC engages in exclusionary conduct by delaying or denying the provision of conditioned unbundled loops that the CSC needs to serve single-line business customers. As a result, the CSC's subscriber growth (in terms of number of customers) is reduced. We assume that the ILEC expands its own output to make up for the reduced output of its competitor, leaving the usage-sensitive market price for the various retail services unaffected.⁴⁴

50. Based on the assumptions described in more detail in the Appendix A, we find that in the retail market, the ILEC gains monthly revenue of approximately \$89.50 per subscriber diverted from the CSC. These revenues are derived from the sale of both local and long-distance service. Our underlying assumptions lead to the ILEC's having retail costs of about \$37.50 per subscriber per month. The resulting retail margin is approximately \$52.00 per month per customer diverted from the CSC.⁴⁵

51. On the wholesale side, for every customer diverted from the CSC, the ILEC

⁴³ As with local calls, intra-region traffic is assumed to be in balance and net payments are assumed to be zero.

⁴⁴ Note that consumers are worse off as the result of the ILEC's exclusionary behavior—they are denied the benefits of the lower monthly charge and the convenience noted in footnote 39 *supra*.

⁴⁵ In explaining this scenario, we find it clearer to include the profits from terminating access in the retail side of the incentive. Only the unbundled loop margin is included on the

sacrifices the margin earned on an unbundled loop. We assume that the price per loop is \$14.50 and the long run incremental cost is \$12.00. Thus, the assumed wholesale margin is \$2.50. If instead we used short-run marginal cost (which is assumed to be zero), then the upstream margin would equal \$14.50.

52. Applying these assumptions to calculation of the *relative-margin incentive*, we find that the exclusion is highly profitable. Using either short-run or long-run incremental costs, the retail margin is substantially larger than the access margin. The retail margin exceeds the access margin by approximately \$37.50 (*i.e.*, \$52.00 – \$14.50) even taking the marginal cost per loop to be zero.⁴⁶ The difference rises to approximately \$49.50 (*i.e.*, \$52.00 – \$2.50) in the longer run, using the long run incremental cost for the loops. Given the way in which we have parametrized our example, $\lambda = 1$.⁴⁷ Substituting the relevant values into Equation (3) shows that, when the diversion ratio is equal to unity, exclusionary conduct increases profits in the absence of detection and regulatory sanction.

53. Even if the ILEC does not capture all of the customers lost by the CSC (that is, even if the diversion ratio δ is less than one), it is still likely that exclusion would be

wholesale side. This choice of labeling has no effects on the conclusions.

⁴⁶ This comparison uses the long-run incremental cost of the loop (\$12) when computing the retail margin, and the short-run marginal cost (\$0) of the loop in computing the wholesale margin, and thus is conservative.

⁴⁷ This follows from the assumption that the CSC reaches each of its customers through an

profitable. Ignoring the risk of sanctions, as long as the diversion ratio exceeds 28 percent, the exclusion is profitable using the short-run marginal cost of loops. Using long-run costs, exclusion is profitable as long as the diversion ratio exceeds 5 percent. The diversion ratio is likely to be much closer to unity in the light of the ILECs' near-monopoly positions in local exchange markets and the likelihood that they would disadvantage all of their CSC rivals simultaneously. Thus, the ILEC in this example would likely have strong incentives to delay or deny the provision of unbundled loops to the CSC. These exclusionary incentives would then have to be balanced against the risk of regulatory detection and sanctions. In the light of imperfections of regulation, the fear of regulatory sanctions is unlikely dominate the incentives to exclude.

54. While the scenario is hypothetical, the example suggests that ILECs like SBC and Ameritech can have significant incentives to engage in exclusionary behavior even in the absence of the merger. As shown in Section V, these incentives would be even larger if the proposed merger were allowed to be consummated.

C. The Exercise of ILEC Market Power Harms Efficiency, Competition, and the Public Interest

55. Competing telecommunications providers obviously are harmed when an ILEC has significant market power and exercises that power by setting inefficiently high monopolistic access prices or by denying, delaying, or degrading the access below the efficient level. The

unbundled loop purchased from the ILEC.

adverse effects on consumers and efficiency go beyond this harm to competitors. These broader adverse effects raise serious public policy concerns. The market suffers efficiency losses because the incentives to invest in R&D and physical infrastructure to provide these competitive local and long-distance services are reduced. Moreover, the costs of retail services will be increased, which can be expected to raise the retail prices paid by consumers and thus lower consumer welfare and suppress output below efficient levels.

D. Regulators Will Be Unable to Prevent the Anticompetitive Exercise of ILECs' Market Power Over Innovative New Access Arrangements

56. In the light of these welfare-reducing effects of this exclusionary conduct, there is a public interest in limiting such behavior. This is, however, very difficult for regulators to do for two fundamental reasons. First, as discussed in the remainder of this part, regulation is imperfect at detecting and correcting such conduct, particularly for new and innovative forms of access. Second, as discussed in Section VI below, the potential for continued consolidation of the large ILECs will further reduce policy makers' ability to exercise effective oversight. SBC and Ameritech have argued that, even if there were problems with the potential exercise of market power, regulatory oversight could sufficiently handle any potential problems.⁴⁸ Analysis of the facts indicate otherwise.

⁴⁸ See, *Merger of SBC Communications Inc. and Ameritech Corporation: Description of the Transaction, Public Interest Showing and Related Demonstrations*, filed with the Federal Communications Commission, July 24, 1998, at 90-91. "Within SBC's or

Even if the Commission were to believe that it can prevent serious abuses in the standard provision of “plain vanilla” interexchange access—a position that some market participants might dispute—future interconnection and access issues will be much more difficult to resolve.⁴⁹ For existing interLATA arrangements, policy makers have built up experience over a number of years in detecting and addressing problems with the provision of access. The development of performance standards has been facilitated by the possibility of benchmarking, whereby the performance of one ILEC is judged in comparison with the performance of other ILECs. In this regard, it is significant that these standards were set when ILECs had less incentive to engage in exclusionary or discriminatory behavior than they do in the present economic and regulatory environment.

Ameritech’s regions, the merger will not in any way alter or diminish the ability of others to compete in local exchange markets. Neither competitors, state commissions nor this Commission will allow any backsliding in the market-opening process.”

⁴⁹ For example, a recent affidavit submitted by Dale Hatfield observed that the ILECs have been substantially increasing the extent to which their networks are intelligent, a change that increases the ILECs' ability to tailor their services to individual customers. "But this very ability to customize means that the BOCs or other [ILECs] can 'fine tune' their local exchange networks to favor (a) their own interexchange operations over their interexchange carrier competitors and/or (b) their own end user customers over the end user customers of their interexchange competitors. Stated another way, the incumbent local exchange carriers, including Ameritech, will have additional--and generally more subtle--methods of discrimination available to them." [Note omitted.] Affidavit of Dale N. Hatfield on Behalf of MCI Telecommunications Corporation, Before the Federal Communications Commission, *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA services in Michigan*, CC Docket No. 97-137 (June 5, 1997), at 15.

57. The situation is quite different for access between ILECs and CLECS, and for access in support of new interexchange and combined services. Access arrangements between ILECs and local service providers are far from fully set in place. Both market participants and regulators have little experience with how these arrangements will work under commercial conditions. Moreover, as both local and long distance service providers launch new services, there will be a variety of new, innovative access arrangements needed to facilitate xDSL and other new technologies. For these arrangements, policy makers do not have the benefit of long experience in detecting and correcting problems. Nor have policy makers had the chance to develop comprehensive performance standards. Further, the information needed to regulate ILEC behavior may be extremely difficult to obtain. How, for example, would the regulators rapidly determine that an ILEC was leaving unused (or underused) equipment in a central office in order to block CLEC or CSC collocation? And what sort of rules would govern interference among digital signals in a binder group? In addition, as discussed in more detail in Section VI below, the merger will make benchmarking more difficult by reducing the number of ILECs and distorting their incentives. For all of these reasons, if SBC were to refuse to provide efficient new access arrangements, delayed or slowed deployment, or reduced the quality of the access below the efficient level, regulators would face significant difficulties detecting the distortions and inducing SBC to correct its misbehavior.

58. The fact that SBC and Ameritech must obtain Section 271 approval before providing interLATA services does not change this conclusion. Unless the Commission interprets the Section 271 standard as requiring that a Bell company face very substantial actual local exchange competition before being allowed to offer in-region interLATA services, a Bell company's meeting this standard will not imply that the company has a non-dominant market position. In all likelihood, CLECs and CSCs will remain dependent on the ILEC for the UNEs they need to compete long after Section 271 approval has been granted. And CLECs, CSCs, and IXC's will remain dependent on the ILEC for various other access services as well. All of the problems of detection and enforcement discussed above will arise whether or not Section 271 approval has been granted. And, perhaps most important, all of these problems will occur for the significant interim period prior to the granting of Section 271 approval.

59. In summary, the roll-out of Sprint ION and similar services by competing carriers is threatened by exclusionary behavior by ILECs. Long, drawn-out litigation and regulatory proceedings will not resolve the issues soon enough to facilitate the rapid entry and expansion that Sprint has planned.⁵⁰ This is unfortunate because such entry would help to bring increased competition to local exchange markets. While policy makers should not give up trying to limit exclusionary conduct through direct oversight, it is important to ensure that competitive market forces can be used wherever possible. And it

is equally important that market conditions not be allowed to deteriorate in ways that increase the incentive and ability of ILECs to exercise market power. As the next section explains, blocking the proposed merger is one way to promote competitive market forces and limit the incentives and ability for SBC and Ameritech to carry out exclusionary conduct.⁵¹

V. THE PROPOSED MERGER WOULD INCREASE SBC AND AMERITECH'S INCENTIVES AND ABILITY TO EXCLUDE RIVALS BY DENYING ACCESS

A. Exclusion By One ILEC Benefits Other ILECs

60. In the light of the strong network effects and the ILECs' dominant position as providers of local loop services, the ILEC provision of access services to other carriers under reasonable terms is essential to the ability of rivals to compete effectively in the local exchange and interexchange markets. As already discussed, ILECs have an incentive to raise rivals' costs in order to achieve, maintain or enhance market power in the provision of local exchange and interexchange services. The proposed merger between SBC and Ameritech would increase their incentives to disadvantage CLEC, CSC and IXC competitors by foreclosing them from efficient access at reasonable prices.

⁵⁰ *Brauer Affidavit* at 20.

⁵¹ Moreover, as discussed in Section VI below, blocking the proposed merger will preserve competitive benchmarks as a means of using market-generated information to improve the regulation of all large ILECs.